8500 ALTERNATIVE MINIMUM TAX

The Federal alternative minimum tax (AMT) was enacted as a response to perceived abuses of the tax system. Congress believed that many taxpayers with substantial economic income were able to avoid paying income tax by utilizing exclusions, deductions, and tax credits. The Federal AMT is an alternative tax structure that responds to this problem by applying a single rate of tax to a tax base, which is intended to be more representative of "true economic income." It is a tax system unto itself, which is entirely distinct from, and runs parallel to, the regular tax system.

The current federal AMT took effect for tax years beginning in 1987. Effective for taxable years beginning on or after January 1, 1988, California substantially conformed to the federal AMT by incorporating with modifications IRC §55 - IRC §59 (R&TC §23400).

The AMT rules are still evolving, and quite a few changes have been made since the original enactment. When considering issues in this area, auditors should always refer to the law for the particular year they are examining to determine the applicable rules for that year. Since the rules are very specific, the discussion in this manual is intended only to provide a general overview of the major AMT provisions and to point out significant federal/state differences.

Reviewed: December 2002

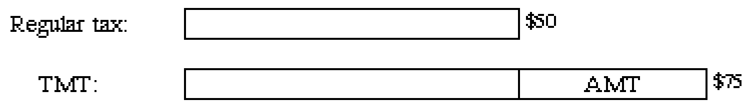
8510 OVERVIEW OF THE AMT MECHANICS

The new AMT provisions create an entire parallel system of taxation that is required to be computed by all corporations with income over $40,000.

The AMT is based on Alternative Minimum Taxable Income (AMTI). The basic calculation of the AMT is as follows:

Basic AMT Calculation	**Discussion:**
Net Income After State Adjustments ± Adjustments + Preference Items = Pre-Adjustment AMTI before ACE Adjustment and NOL	The computation starts with regular California net income after state adjustments. Net income is then reduced or increased by adjustments, and increased by preference items to derive "pre-adjustment AMTI."
Apportionment provisions are applied. = California pre-adjustment AMTI	At this point, the separate AMTI amounts of the members of a unitary group are combined, and apportionment and allocation procedures are applied to derive the California AMTI.
± ACE Adjustment = AMTI before NOL - AMT NOL Deduction = AMTI before Exemption	The ACE Adjustment and AMT NOL are applied on an individual taxpayer basis as explained in MATM 8540.
- Exemption = AMTI	A maximum exemption of $40,000 is allowed for each taxpayer.
x 7% Tax Rate = Tentative Minimum Tax (TMT)	After being reduced by the exemption amount, AMTI is taxed at a 7% rate to derive TMT.
- California Regular Tax = Alternative Minimum Tax	If the TMT exceeds the regular tax, the excess is the alternative minimum tax (AMT).

The AMT for general corporations is the incremental portion of the tentative minimum tax (TMT) that exceeds the regular tax. If the regular tax exceeds the TMT, there is no AMT. This concept can be illustrated as follows:



In this illustration, regular tax is $50, and tentative minimum tax is $75. The AMT is $25.

Since AMT is the excess of TMT over the regular tax liability, an increase to regular tax may decrease or possibly eliminate AMT. This is a factor that auditors need to consider when determining the materiality of an audit issue.

Before surveying a return on the assumption that the AMT effect will result in insufficient tax potential however, the auditor and supervisor should consider the fact that the AMT is generally considered a prepayment of tax. In years when the TMT exceeds the regular tax, a minimum tax credit is generated (see MATM 8580). That credit can be carried forward to offset the regular tax in years when the regular tax exceeds TMT. Although increasing the regular tax and reducing AMT may not result in a large tax effect in the current year, the minimum tax credit carried over to subsequent years will be reduced. This may have a substantial effect in future years. Furthermore, by the time that the minimum tax credit is used, the SOL for the year of the income adjustments may have expired. If a timely NPA has not been issued, we may be barred from revising the amount of the minimum tax credit carryover (see MATM 9010).

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8520 ADJUSTMENTS

IRC §56, which California incorporates with modifications in R&TC §23456, requires taxpayers to treat certain items differently in the calculation of alternative minimum taxable income (AMTI) than those items would be treated in the calculation of regular taxable income.

Depreciation: For AMT purposes, most property placed in service after 1986 must be depreciated using the methods described in IRC §56(a). Generally, real property is depreciated using the straight-line method over a specified life. Personal property that has not been depreciated under the straight-line method for regular tax purposes must generally use the 150% declining balance method for AMT purposes, changing to the straight-line method in the first year in which the straight-line method yields a higher deduction. The AMT adjustment is the difference between the depreciation deduction computed under the AMT method and the depreciation computed for regular tax purposes.

Although California adopts this provision without modification, there will usually be federal/state differences in the amount of the adjustment because of differing depreciation methods used for regular tax purposes. Unless the taxpayer has used the straight-line or 150% declining balance method for regular tax, there should always be a depreciation adjustment for AMT.

Basis adjustments in determining gain or loss from sale or exchange of property: For AMT purposes, the adjusted basis of property is equal to the cost of the asset less accumulated AMT depreciation. Obviously, if the adjusted basis is different for AMT purposes than for regular tax purposes, there will be a different gain or loss on disposition. In years where the corporation sells an asset, there should be two adjustments to AMTI, the depreciation adjustment and the gain adjustment [IRC §56(a)(7)].

Mining and exploration and development costs: The federal requirement that certain mining exploration and development costs be amortized for AMT purposes over a ten-year period applies in California only to expenses incurred during taxable years beginning after January 1, 1988 (under federal law, the requirement applies to costs incurred after December 31, 1986) [IRC §56(a)(2); R&TC §23456(a)(1)]

Long-term contracts: The percentage-of-completion method must be substituted for the completed-contract method in the determination of AMTI for any long-term contracts entered into on or after March 1, 1986. For certain small construction contracts, simplified procedures for allocation of costs must be used [IRC §56(a)(3)]. California conforms to this provision without modification. Because of federal/state differences in the effective dates of long-term contract rules for regular tax purposes, there may be some federal/state differences in the amount of the AMT adjustment.

Pollution control facilities: The five-year depreciation method available under IRC §169 for such facilities must be replaced for AMT purposes by the alternative depreciation system specified under IRC §168(g) (straight-line method, without regard to salvage value) [IRC §56(a)(5)]. Unlike federal law, California law allows the use of the five-year depreciation provision only if the facility is located in California and certified by the State Department of Health Services (prior to 1993) or the State Air Resources Board or State Water Resources Control Board (1993 and subsequent) (R&TC §24372.3). Therefore, federal/state differences may arise in connection with facilities located outside the state. [R&TC §23456(a)(2)]

Installment accounting method: The installment method may not be used in AMTI computations for dispositions of property described in IRC §1221(1). Gains from an installment sale must be recognized in the year of disposition.

Merchant Marine capital construction funds: California does not conform to this adjustment.

Blue Cross Blue Shield Organizations: California law does not provide for this deduction, therefore there is no adjustment for California AMT purposes.

Energy Preferences: From 1990 - 1992, federal law allowed a deduction from AMTI based upon energy preferences (IRC §56(h)). California did not conform to this deduction. (R&TC §23456(f).)

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8530 TAX PREFERENCE ITEMS

California incorporates, with modifications described below, IRC §57, which designates as tax preference items (TPIs) certain items that are accorded favorable tax treatment. Because TPIs have the effect of reducing regular taxable income, the amounts described below must be added back in the computation of alternative minimum taxable income (AMTI):

In the calculation of the AMTI, the following items are considered tax preference items:

Accelerated depreciation or amortization of pre-1987 property: For federal purposes, depreciation on property placed in service before January 1, 1987 is a preference item to the extent that it would have been considered a tax preference item under federal law prior to the 1986 Tax Reform Act [IRC §57(a)(6)]. The preference item will generally be the amount by which accelerated depreciation on real property exceeds straight-line depreciation. California modifies the language of this provision, but also considers depreciation deducted on pre-1987 real property to be a tax preference item to the extent that the amount exceeds the depreciation computed under the straight-line method (R&TC §23457(d)). Because of the differences in accelerated depreciation methods for federal and state purposes, there will usually be a federal/state difference in the amount of the preference item.

Depletion: The excess of the percentage depletion deduction over the adjusted basis of the property at the end of the taxable year is a tax preference item for both federal and state purposes [IRC §57(a)(1); R&TC §23457].

Intangible drilling costs: For both federal and state purposes, tax preference items include the amount by which "excess intangible drilling costs" (as defined in IRC §57(a)(2)(B)) exceed 65% of the taxpayer's net income from oil, gas, and geothermal properties (IRC §57(a)(2); R&TC §23457).

Bad-debt reserves of financial institutions: The amount by which the reserve deduction allowed for regular tax purposes exceeds the amount that would have been allowable on the basis of actual experience is a tax preference item [IRC §57(a)(4)]. For California purposes, this provision affects banks for 1988 through 1990 only, and savings and loan associations for 1988 and thereafter.

Tax-exempt interest: Although interest from specified private activity bonds is added back as a tax preference item for federal purposes, California does not incorporate that federal provision. This is not a preference item for California purposes. [R&TC §23457(a)]

Charitable deduction for appreciated property: For AMT purposes, deductions for charitable contributions of appreciated property are limited to the adjusted basis of the property. For contributions made on or before June 30, 1992 (or December 31, 1992 depending on the type of property contributed), if the fair market value of the appreciated property was allowed as a deduction for federal regular tax purposes, then a federal preference item would be required to add back the amount of the deduction that exceeded the adjusted basis of the property (IRC §57(a)(6)). California law is more limited than federal law with respect to allowing charitable deductions that exceed the adjusted basis of the contributed property. As a result, the California AMT add-back of excess charitable deductions may not be required, or may be smaller than the federal add-back.

The federal preference for contributions of appreciated property was repealed for contributions made after June 30, 1992 (or December 31, 1992). The repeal was pursuant to P.L. 103-66, which was not enacted until August 1993. California conformed to the Internal Revenue Code as it existed on January 1, 1993 until 1997. Then, for taxable years beginning on or after January 1, 1997, R&TC §23457 was revised to specifically include excess deductions for contributions of appreciated property as a preference item. Therefore, for California purposes, excess contributions of appreciated property are and have continued to be a preference item.

Capitalization of certain costs: IRC §59(e) provides for an optional amortization period for certain items that would ordinarily be tax preferences. If taxpayers make this election, then the items will not be not be treated as tax preference items under IRC §57(a), and no AMT adjustments under IRC §56 will be required. For corporations, these items include mining exploration and development costs and intangible drilling costs. (R&TC §23459.)

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8540 APPORTIONMENT & ALLOCATION OF PRE-ADJUSTMENT AMTI

The result of adjusting net income or loss after state adjustments by AMT adjustments and tax preference items is the Pre-Adjustment AMTI before BURP/ACE adjustments and NOL.

Generally, the calculation of AMTI must incorporate the same concepts used in the calculation of regular California taxable income. Furthermore, AMTI may consist of both business and nonbusiness amounts. The pre-adjustment AMTI of the members of a combined group must therefore be combined, allocated or apportioned to California, and intrastate apportioned to each member in the same manner as is regular taxable income. These computations may be performed by running pre-adjustment AMTI through the Schedule R, or through computerized audit schedules that will calculate the apportionment. An example of the necessary computations may also be found in the FTB Publication 1061, *Guidelines for Corporations Filing a Combined Report.*

The apportionment factors used to apportion pre-adjustment AMTI should reflect AMT rules, and this may create factor differences if the taxpayer has significant long-term contracts, installment sales, or intangible drilling costs.

When performing the allocation and apportionment computations, remember that the amount of any nonbusiness income or loss for AMT purposes should include any increases or decreases for tax preference or adjustment items, such as accelerated depreciation directly related to such income. For regular tax purposes, nonbusiness income or loss allocable outside California is not included in the tax base, and the same holds true for AMT purposes. Once the apportionment and allocation computations are performed, only the California AMTI will remain.

In addition to apportioning and allocating AMTI to California, AMTI must be intrastate apportioned among each of the California taxpayers using the computations described in MATM 7900 and in the FTB Publication 1061. From this point on, the AMT calculations will be made on a taxpayer-by-taxpayer basis. Each taxpayer in the combined report will calculate its own ACE adjustment, AMT NOL, exemption amount, AMT liability, and tax credits.

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8545 BOOK UNTAXED REPORTED PROFITS (BURP) ADJUSTMENT

For taxable years beginning in 1988 or 1989, AMT included a Book Untaxed Reported Profits (BURP) adjustment (IRC §56(f); R & TC §23456(d)). (Beginning in 1990, the BURP adjustment was replaced by the ACE adjustment; see MATM 8550.) The BURP adjustment is an inclusion of net income from the corporation's financial earnings rather than just a modification of an item on the tax return. This concept was influenced by publicity of major corporations paying no income taxes in years when they reported substantial earnings.

The BURP adjustment increases taxable income by 50% of the excess of adjusted net book income (ANBI) over AMTI. The BURP adjustment may never decrease AMTI. The computations involved in making the adjustment are as follows:

	Net Book Income per Applicable Financial Statements
±	Adjustments to Book Income
=	Adjusted Net Book Income (ANBI)
-	Taxable Income after certain AMT adjustments
=	Difference
X	50%
=	BURP adjustment

Net book income is the starting point in the computation and is defined in Treas. Reg. §1.56-1(b). The term generally means the income or loss reported in the "Applicable Financial Statement." Net book income must include all items of income, expense, gain or loss for the taxable years (whether or not such items were recognized for tax purposes), including extraordinary items, results from discontinued operations and cumulative adjustments resulting from accounting method changes. IRC §56(f) (3) provides the definition of the applicable financial statements, and provides an order of priority for use in determining which financial statement to use.

The adjustments required to compute the adjusted net book income are listed in IRC §56(f), as modified by R&TC §23456(d).

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8550 ADJUSTED CURRENT EARNINGS (ACE) ADJUSTMENT

For taxable years beginning on or after January 1, 1990, the BURP adjustment is replaced by the Adjusted Current Earnings (ACE) adjustment. Like the BURP adjustment, the ACE adjustment is also intended to make AMTI more representative of economic income. The ACE adjustment is computed by adjusting the pre-adjustment AMTI by 75% of the difference between "adjusted current earnings" and pre-adjustment AMTI. The adjustment follows this formula:

	Adjusted Current Earnings
-	Pre-adjustment AMTI
=	Difference
X	75%
=	ACE adjustment

Unlike the BURP adjustment, which may only increase AMTI, an ACE adjustment may either be positive or negative. If adjusted current earnings are greater than pre-adjustment AMTI, a positive adjustment will result; if adjusted current earnings are less than pre-adjustment AMTI, the adjustment will be negative. Negative ACE adjustments are limited however, and will only be allowed to the extent that the corporation's aggregate positive ACE adjustments in prior years exceeded that corporation's aggregate negative adjustments in prior years. Negative adjustments that are not allowed in one year due to this limitation cannot be carried over to any other taxable year.

The ACE adjustment must be made on a post-apportionment basis, and is calculated for each taxpayer in a combined group. To perform this calculation, pre-adjustment AMTI is combined, apportioned or allocated to California, and intrastate apportioned to each taxpayer as described in MATM 8540. Adjusted current earnings are also combined, apportioned or allocated to California, and intrastate apportioned to each taxpayer in the same manner. Each taxpayer in the combined group then calculates its ACE adjustment by comparing its share of California pre-adjustment AMTI with its share of California adjusted current earnings. An example of this computation can be found in the FTB Publication 1061, Guidelines for Corporations Filing a Combined Report.

Adjusted Current Earnings
To derive "adjusted current earnings," pre-adjustment AMTI is modified by the adjustments listed in IRC §56(g)(4) and R&TC §23456. The adjustments necessary to compute adjusted current earnings are as follows:

Depreciation
California adopted the federal ACE depreciation adjustments specified in IRC §56(g)(4)(A), with certain modifications (R&TC §23456(e); R&TC §23456(g) beginning in 1994). Generally, the straight-line method must be used to compute depreciation for ACE purposes. The depreciable basis and the

recovery period will vary depending upon when property was placed in service. The adjustment required is the difference between the depreciation allowable for ACE purposes and the depreciation allowable for alternative minimum taxable income purposes.

For ACE purposes, the adjusted basis of property must reflect the depreciation allowable under the ACE rules. [IRC §56(g)(4)(I)]

Inclusion of Items Included in Earnings & Profits
Generally, IRC §56(g)(4)(B) provides that adjusted current earnings shall include all income items which are not taken into account in determining pre-adjustment AMTI but which are taken into account for E & P purposes. Treasury Regulation 1.56(g)-1(c)(6) provides a partial list of these items.

Federal/state differences may occur due to differences in the way that items are reported for regular tax purposes. For example, interest on state and local bonds is generally excludable from federal AMTI, but is an adjustment for federal ACE purposes because it is included in earnings and profits. For California purposes, only interest from California obligations is excludable from AMTI. Therefore, the California ACE addback may differ from the federal addback. In addition, if a corporation is subject to the corporate income tax rather than the franchise tax, R&TC §23456(f)(4) provides that the amount of interest income included in adjusted current earnings may not exceed the amount included for purposes of the regular tax.

Disallowance of Items not Deductible in Computing Earnings and Profits
IRC §56(g)(4)(C) provides that adjusted current earnings may not be reduced by deductions not allowable against E & P, even if the deductions were taken into account in determining pre-adjustment AMTI. California law modifies the federal provisions as follows:

California does not follow the federal provisions relating to dividend deductions. Instead, California allows dividends to be deducted from adjusted current earnings in accordance with the dividend deductions allowed for regular tax purposes. (R&TC §23456(f)(1)).

California's interest offset rules (R&TC §24344) must be applied in determining the amount of interest deductible for purposes of adjusted current earnings. In addition, no deduction from adjusted current earnings will be allowed for interest expense allocable to income that has not been included in the measure of tax (R&TC §24425). (R&TC §23456(f)(4).)

Intangible Drilling Costs, Circulation and Organizational Expenses
For ACE purposes, these expenses are required to be capitalized rather than currently deducted. Since there may be federal/state differences in the treatment of these items for regular tax purposes, there may be differences in the amount of the adjustment required for ACE.

Depletion

For any property placed in service in a taxable year beginning after 1989, the depletion deduction for ACE purposes must be computed under the cost depletion method. (An exception is made for independent oil and gas producers and royalty owners.)

Other Adjustments Required to Compute Adjusted Current Earnings
In addition to the adjustments summarized above, IRC §56(g)(4) requires adjustments related to life insurance contracts, LIFO inventory adjustments, installment sales, exchanges of debt pools, and certain ownership changes.

Reviewed: December 2002

8560 AMT NOL DEDUCTION

The key features to remember about AMT net operating losses (NOLs) are:

AMT NOLs must be computed on the basis of AMTI; and
an AMT NOL deduction may not offset more than 90% of the AMTI for any taxable year.

In other respects however, the computation of the AMT NOL is subject to the same rules and limitations as regular tax NOLs (i.e., the 50% limitation, water's-edge NOL limitations, IRC §382 limitations, etc.; see MATM 8000). As with regular tax NOLs, each taxpayer in a combined group must apply its separately apportioned or allocated share of California AMT NOL to its apportioned or allocated share of AMTI.

NOTE: Taxpayers often forget to apply the 50% California NOL limitation to AMT NOLs, or forget to limit the AMT NOL to 90% of AMTI. Since these are fairly common mistakes, auditors should be especially careful to review taxpayers' AMT computations for these issues.

The federal AMT NOL provisions are IRC §56(a)(4) and IRC §56(d). California conforms to those provisions, but modifies the applicable dates pursuant to R&TC §23456(c)(1). Legislation in 1994 added R&TC §23456(d) to clarify how California's NOL rules for apportioning taxpayers interact with the AMT rules.

Since NOLs arising from tax years beginning before January 1, 1988 cannot be based upon AMTI, former R&TC §23456(c)(2) provided rules for determining the amount of AMT NOL to carry forward from those years.

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8565 EXEMPTION AMOUNT

California incorporates IRC §55(d), which exempts the first $40,000 of alternative minimum taxable income from the alternative minimum tax. The exemption amount is reduced (but not below zero) by an amount equal to 25% of the amount by which the AMTI of a corporate taxpayer exceeds $150,000. The exemption is zero if the AMTI is greater than or equal to $310,000. (R&TC §23455)

Each California taxpayer in a combined group has its own $40,000 exemption, and applies its own $150,000 limitation. The exemption and limitation are applied against the California AMTI apportioned and allocated to that taxpayer.

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8570 TENTATIVE MINIMUM TAX

For general corporations, the tentative minimum tax is 7% of that portion of the taxpayer's alternative minimum taxable income (AMTI) that exceeds the exemption amount (R&TC §23455(a)). Corporations with valid S-Corporation elections are not subject to the AMT.

The tentative minimum tax (TMT) is compared to the taxpayer's regular tax. For purposes of this comparison, the "regular tax" is defined as the corporation franchise tax, the corporation income tax, or the tax on the unrelated business income of an exempt corporation. The comparison is made before the application of any tax credits.

If the TMT exceeds the regular tax, the difference is the Alternative Minimum Tax. Notwithstanding tax credits, the taxpayer is effectively required to pay the higher of the TMT or the regular tax for the taxable year.

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8575 INTERACTION WITH TAX CREDITS

Once the tentative minimum tax (TMT) and alternative minimum tax (AMT) have been determined, then any tax credits may be applied. Most tax credits are not allowed to reduce the tax liability below the TMT amount. Only certain credits may reduce the regular tax below the TMT amount, and only carryovers from certain repealed versions of the solar energy credit are allowed to offset the AMT.

The credits that are allowed to reduce the tax liability below the TMT are listed in R&TC §23036. That section also provides the ordering rules for applying credits. Those rules are also discussed in MATM 9010.

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8580 ALTERNATIVE MINIMUM TAX CREDIT

To the extent that a taxpayer's TMT exceeds the regular tax, a Minimum Tax Credit (MTC) is generated. The MTC may be carried forward and applied against the regular tax in a year when regular tax exceeds TMT. The amount of MTC that can be applied in any one-taxable year is limited because the MTC cannot reduce regular tax below the TMT, but any unused MTC can be carried forward indefinitely. (IRC §53, R&TC §23453.)

The MTC reflects the intent of Congress for the alternative minimum tax system to be largely a pre-payment of tax. Many AMT adjustments are timing adjustments or deferrals that will turn around in subsequent years. The theory is that if taxpayers pay AMT on an item, they will be allowed a benefit in the subsequent year when the item results in a smaller deduction for regular tax purposes than for AMTI. In fact, for 1988 and 1989, a MTC was only generated to the extent that the AMT resulted from deferral items. For taxable years beginning on or after January 1, 1990, the MTC was expanded to apply whether the AMT was due to deferral items or permanent differences.

Minimum Tax Credits Generated in 1988 and 1989:

For 1988 and 1989, the MTC could only be generated to the extent that the AMT resulted from deferral items. Permanent items such as the preference items for depletion and appreciated property charitable contributions would not produce any MTC. If the normal AMT computation resulted in an AMT liability (TMT exceeds regular tax), a "with and without" computation was required to identify the portion of the AMT that was not due to deferral items.

Example: Assume that in 1989, the taxpayer has regular taxable income of $3,000,000 and has a regular tax liability of $279,000. The taxpayer's AMT preference and adjustment items are as follows:

Depletion (permanent item)	$ 1,250,000
Accelerated Depreciation	750,000
Mining Exploration and Development Costs	2,000,000
Total AMT Preferences/Adjustments	$ 4,000,000

Tentative Minimum Tax [$3,000,000 + $4,000,000) x 7%]	$ 490,000
Regular Tax	279,000
AMT	$ 211,000

Question: How much of the $211,000 AMT amount is available for carryforward as a MTC?

Answer: $192,500, the AMT less the AMT computed with only permanent items:

TMT computed with only permanent items (($3,000,000 + 1,250,000) x 7%)	$ 297,500
Regular Tax	279,000
AMT generated solely by permanent items	18,500
AMT computed with all items	211,000
Difference: AMT attributable to deferral items	$ 192,500

Minimum Tax Credits Generated After 1989:

For taxable years beginning on or after January 1, 1990, the MTC for corporations is no longer limited to deferral items (IRC §53(d)(1)(B)(iv)). The MTC may now be produced by the entire amount of AMT. If the facts of the previous example had occurred in 1990, the MTC generated would have been $211,000.

Application of MTC carryover:

The following example will illustrate how the MTC carryover is applied:

Example: The first year in which the taxpayer's tentative minimum tax exceeded its regular tax was 1990. Assume the following facts for 1990 and 1991:

	1990	**1991**
Tentative Minimum Tax	147,856	120,000
Regular Tax	54,928	140,000
AMT	92,928	--

Since the TMT exceeded the regular tax, a minimum tax credit of $92,928 was generated in 1990.

In 1991, regular tax exceeded TMT by $20,000. Assuming that the taxpayer has no other tax credits, $20,000 of the MTC may be applied in 1991 to reduce the regular tax liability to $120,000. The remaining $72,928 MTC will be carried forward to subsequent years.

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